IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. 73-5265

HENRY A. KOKOSZKA, Bankrupt,

Petitioner

v.

RICHARD BELFORD, Trustee in Bankruptcy of the Estate of Henry A. Kokoszka, Bankrupt,

Respondent

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITIONER'S BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

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OPINIONS BELOW

The opinion of the Court of Appeals (App. 27) is reported at 479 F.2d 990. The opinions of the District Court for the District of Connecticut (App. 21) and of the Referee in Bankruptcy (App. 4) are unreported.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was entered on May 18, 1973. Petition for writ of

certiorari was filed on August 10, 1973, within 90 days of the date of entry of the judgment. The jurisdiction of this Court rests on 28 U.S.C. Sec. 1254(1).

STATUTES INVOLVED

The statutory provisions involved herein are Bankruptcy Act Sec. 6, 11 U.S.C. Sec. 24; Bankruptcy Act, Sec. 70a, 11 U.S.C. Sec. 110a; and Consumer Credit Protection Act, 15 U.S.C. Sections 1671, 1672, 1673. The statutes are set forth in Appendix A.

QUESTIONS PRESENTED

1. Does a refund of wages involuntarily withheld from a wage-earning bankrupt in excess of his income tax liability become part of his bankruptcy estate as held by the court below, or is such a refund excluded from the purview of Sec. 70a of the Bankruptcy Act under the fresh start doctrine?

2. Assuming *arguendo* that some or all of the refund is property which vests in the trustee, does this refund of wage withholding receive the same exemption as to 75% thereof applicable to all other wage payments under the provisions of the Consumer Credit Protection Act, 15 U.S.C. Sec. 1671, *et seq.*?

STATEMENT OF THE CASE

Petitioner Henry A. Kokoszka had been employed for the first three months of 1971, was unemployed from April, 1971, to late December, 1971, and was re-employed for about the last week and a half of December, 1971. He received unemployment compensation during this long period without wages.

While employed, Mr. Kokoszka had two exemptions for federal income tax purposes and so advised his

employer. (App. 15). Accordingly, and pursuant to Internal Revenue Code withholding tables, the employer withheld an appropriate portion of his wages.

During the year 1971, Mr. Kokoszka's gross income was $2,322 (App. 19), which, under the tax laws, entitled him to a refund of the entire amount withheld, $250.90. It seems clear that this refund arose because the periodic withholdings from his pay were under a tax table geared to a full year's employment, which in fact did not occur.

Petitioner Henry A. Kokoszka filed his voluntary petition in bankruptcy on January 5, 1972. (App. 1, 15). The sole asset* claimed by the trustee in bankruptcy is a $250.90 refund of petitioner's wages, involuntarily withheld from earnings by his employer pursuant to the federal income tax laws.

On February 3, 1973, the referee in bankruptcy entered his customary *ex parte* order directing the bankrupt, when he received the refund, to turn it over to the trustee. (App. 2). On February 7, 1972, the bankrupt moved to vacate that order. (App. 3).

After hearing, the Referee found that Mr. Kokoszka needed a hernia operation or some form of abdominal support, dental work and eyeglasses. (App. 16). The Referee, however, denied Mr. Kokoszka's motion to vacate the turn-over order. (App. 11).

Kokoszka filed his tax return in mid-February, 1972. (App. 19). Some weeks later, when Mr. Kokoszka received his refund check, he complied with the order by turning it over to the trustee. The trustee is holding the money pending a determination as to whether or to what extent the refund is found to be property of the estate of the bankrupt.

The bankrupt next filed a Petition for Review of the Referee's decision with the District Court of Connecticut under Sec. 39c of the Bankruptcy Act, 11 U.S.C. Sec.

*The trustee abandoned as an asset a 1962 Corvair, upon bankrupt's payment of $25.

67c. The District Court affirmed the order of the Referee. (App. 21).

The bankrupt was granted leave to appeal, pursuant to Sec. 24a of the Bankruptcy Act, 11 U.S.C. Sec. 47a. On May 18, 1973, the Court of Appeals for the Second Circuit affirmed the order of the District Court as to the issues presented in this petition. It concluded: (1) that the tax refund is Sec. 70a(5) property which passes to the trustee; and (2) that the refund is not "earnings" within the Consumer Credit Protection Act and therefore not subject to the restrictions on garnishment.

SUMMARY OF ARGUMENT

A. The bankrupt contends that his income tax refund of $250.90 does not become Sec. 70a(5) property of the bankrupt estate under *Lines v. Frederick*, 400 U.S. 18 (1970). The judgment below is in conflict with *Lines v. Frederick*, and with a decision of the Ninth Circuit applying *Lines* to the same factual situation as exists herein. *In re James*, 470 F.2d 996 (9th Cir. 1972), *cert. den.*, 411 U.S. 973 (1973).

Although "the term 'property' has been construed most generously," for a wage earning bankrupt that term is limited by "the basic purpose of the Bankruptcy Act to give the debtor a 'new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.' " *Lines v. Frederick*, 400 U.S. at 19.

The principles of *Lines* are applicable here to protect bankrupt's tax refund from passing to the trustee, because the tax refund represents the bankrupt's wages, involuntarily withheld and not available to the bankrupt until some weeks after the date of filing. The bankrupt needed the refund to give him a fresh start in life, not one

handicapped by poor health, neglected because of inability to afford medical attention.

The judgment below is inconsistent with the mainstream of this Court's cases regarding the importance of a "fresh start" to a debtor, *e.g., Local Loan Co. v. Hunt*, 292 U.S. 234 (1934), and the importance of protection of a debtor's wages, *e.g., Sniadach v. Family Finance Corp.*, 395 U.S. 337 (1969).

The income tax refund has its sole source in wages and does not change its character as wages merely because it is called by another name. This Court regards wages as "a specialized type of property presenting distinct problems in our economic system". *Sniadach v. Family Finance Corp.*, 395 U.S. at 340. A "debtor's wages are his sustenance, with which he supports himself and his family." *James v. Strange*, 407 U.S. 128, 135 (1972).

The Court must also weigh other purposes of the Bankruptcy Act to decide if an asset is "property". Two of these purposes are to gather assets for the benefit of creditors, and to treat debtors uniformly across the nation. But, the vast majority of income tax refunds are small, and are used mainly to pay trustee's fees and other administrative costs, with little or no money trickling down to the creditor. Furthermore, the great variation in state exemption laws has produced nonuniform treatment of debtors due solely to the fortuity of their residence. A decision that the refunds do not become property would equalize the treatment of bankrupt wage earners.

Segal v. Rochelle, 382 U.S. 375 (1966) is not controlling here because it is factually distinguishable. The refunds there derived from a business tax loss carryover, not from wages. The Court's concern there was to benefit the creditors who had borne the burden of the losses; here the trustee would receive the benefit. *Segal* presented the Court with a close question, 382 U.S. at

379. This case, being more like *Lines*, requires a decision in favor of the wage earning bankrupt.

Accordingly, the Second Circuit was in error when it ruled that a bankrupt wage earner's income tax refund is property which passes to the trustee under Sec. 70a(5) of the Bankruptcy Act.

B. The bankrupt further contends that the restrictions on garnishment of the Consumer Credit Protection Act apply to the refund, if this Court determines that the refund is property which passes to the trustee.

Under the Consumer Credit Protection Act (CCPA), 15 U.S.C. Sec. 1673, 75% of an individual's disposable earnings are exempt from garnishment.

The refund here consists entirely of compensation payable for personal services, thus satisfying the broad definition of earnings in the CCPA. 15 U.S.C. Sec. 1672(a). Once the tax obligation has been determined, the amount refunded is disposable earnings, 75% of which are exempt from garnishment under the CCPA.

The trustee in bankruptcy takes title to property both as an attaching and executing creditor. Bankruptcy Act Sec. 70c, 11 U.S.C. 110c. The bankruptcy court's turnover order deprives the debtor of title to the refund; in fact, the Internal Revenue Service sometimes sends the refund directly to the trustee. This fulfills the definition of garnishment as "any legal or equitable procedure through which the earnings of any individual are required to be withheld for the payment of any debt". 15 U.S.C. Sec. 1672(c).

The U.S. Department of Labor, charged with administering the CCPA, has issued an opinion that the garnishment restrictions apply to all orders in bankruptcy except those Chapter XIII orders specifically exempted. Its construction is entitled to great weight. *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969).

Accordingly, the Second Circuit Court of Appeals was incorrect in concluding that the Consumer Credit Protection Act does not exempt 75% of the income tax refund.

ARGUMENT

I.

BECAUSE IT DERIVES FROM WAGES, AND BECAUSE IT PROVIDES ONLY A MEAGER BENEFIT TO CREDITORS, A WAGE EARNER'S INCOME TAX REFUND, INVOLUNTARILY WITHHELD UNDER THE TAX LAWS, DOES NOT BECOME PROPERTY OF HIS BANKRUPTCY ESTATE.

This case involves the proper disposition of an income tax refund of $250.90 due to be received by a wage-earning bankrupt subsequent to filing bankruptcy. The issue is whether the refund, which is the sole asset claimed for the bankrupt's estate, is "property" as defined by Sec. 70(a) of the Bankruptcy Act.

Although Sec. 70(a) permits creditors to take bankrupts' non-exempt "property", the Act itself does not define "property". Consequently, this Court has observed that "the problem of classification for purposes of the Bankruptcy Act [cannot] be resolved simply by reference to the time when the right to the payment 'vested', or to definitions of property drawn from other areas of the law." *Lines v. Frederick*, 400 U.S. 18, 19 (1970). Rather, "The most important consideration limiting the breadth of the definition of 'property' lies in the basic purpose of the Bankruptcy Act to give the debtor a 'new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt' ". *Id.* at 20.

The rule thus restated in *Lines* has been imbedded in the bankruptcy law for nearly a century. *Segal v.*

Rochelle, 382 U.S. 375, 379 (1966); *Local Loan v. Hunt*, 292 U.S. 234, 245 (1934); *Williams v. U.S. Fidelity Co.*, 236 U.S. 549, 554-5 (1915); *Neal v. Clark*, 95 U.S. 704, 709 (1878); *Traer v. Clews*, 115 U.S. 528, 541 (1885).

The purpose of the Bankruptcy Act is to strike a balance between the interests of the debtor and the creditors. The balance here should tip in the bankrupt's favor, because a contrary result would be inconsistent with the Act's ultimate purposes. The "fresh start" which the Act gives a debtor is the basic reason the Act exists. Congress recognized that individuals can become trapped by a burden of debts they cannot pay. Such a burden not only ruins an individual's personal life, but can lead to counter-productive results such as the loss of a job. The policy allowing release from overwhelming debt is a realistic national policy which serves both the individual and society. REPORT OF THE COMMISSION ON BANKRUPTCY LAWS 87-94 (1973).

A. The Income Tax Refund Is a Wage Payment With the Same Characteristics as the Vacation Pay in *Lines v. Frederick*.

In *Lines v. Frederick*, 400 U.S. 18 (1970), this Court noted that vacation pay, involuntarily accumulated, accrued by a bankrupt wage earner at the date he filed his petition, but not payable until some future time, was part of his wages and was therefore deserving of special protection. It held that the accrued vacation pay did not become "property".

In this case, a fund of money involuntarily withheld from a bankrupt wage-earner, accrued at the date of the petition in bankruptcy, but not available until some future time, was held below to have lost its character as wages, and without that special protection became "property".

"Property" which passes to the trustee under Sec. 70a(5) of the Bankruptcy Act is limited where the debtor is a wage earner "whose sole source of income, before and after bankruptcy, is [his] weekly earnings", who has wages accrued but not payable at the time of bankruptcy. Because the function of wages "is to support the basic requirements of life", "the minimal requirements for the economic survival of the debtor are at stake". *Lines v. Frederick*, 400 U.S. at 20. Forcing the bankrupt to give up his wages is contrary to the purpose of the Bankruptcy Act to give the debtor a "new opportunity in life" and a " 'clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt'." *Ibid.*

Lines and the instant case could hardly be more similar. In *Lines*, the following factors were present: (1) The vacation pay derived solely from the employment and wages of the bankrupt employees; (2) It was earned prior to the filing of the bankruptcy petitions; (3) It was accrued, unpaid and determinable at the time of filing the petitions; (4) The withholding of vacation pay by the employers was involuntary and outside the control of the bankrupts; (5) The fund was unavailable to the bankrupts until it actually became payable, *i.e.*, at the time of vacation or upon termination; (6) It was a planned-on, annually recurring payment, which entered into their families' anticipated annual budgets; (7) Its function was to meet their basic needs.

The wage earner tax refund has all of the above characteristics. In the case at bar: (1) the tax refund is derived solely from the employment and wages of the bankrupt employee; (2) It was earned prior to the filing of his bankruptcy petition; (3) It was accrued, unpaid and determinable at the time of the filing of his bankruptcy petition; (4) The withholding of wages for income taxes was involuntary, 26 U.S.C. Sec. 3402; (5) The tax refund is unavailable to the bankrupt until some

weeks after he has filed his tax return, 26 U.S.C. Sec. 6401 *et seq.*; (6) It is normally a planned-on annually-recurring payment entering into a bankrupt's annual spending budget; (7) Its function was to meet his basic needs, including long deferred medical care.

The function of the refund check was for basic support, exactly as wages are ordinarily used.[1] The court below recognized this (App. 32, n.2.), but found it legally immaterial since the refund was not a periodic wage payment. (App. 32).

That court interpreted *Lines* as being limited to "pay which will become essential for basic week to week support". *In re Kokoszka*, 479 F.2d 990, 994 (1973) (App. 31). That limitation did not exist, since either bankrupt in *Lines* could have terminated, accepted the pay and started a new job instead of taking time off. The Court's concern in *Lines* seemed to be with the "function" of wages as basic support,[2] rather than the use to which they would actually be put.

Speculation as to the actual use of deferred vacation pay and wages withheld for tax purposes is present in

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[1] "The debtor's wages are his sustenance, with which he supports himself and his family. The average low income wage earner spends nearly nine-tenths of those wages for items of immediate consumption." *James v. Strange*, 407 U.S. 128, 135 (1972).

[2] A Brookings Institution study found that the items most commonly purchased by typical bankrupts immediately after a bankruptcy are a vehicle, an appliance, furniture, house and clothing in that order. Stanley & Girth, BANKRUPTCY: PROBLEM, PROCESS, REFORM, 63 (Brookings Inst. 1971).

The Bankruptcy Commission report shows that the median annual income of non-business bankrupts was in the upper $4,000.00 or lower $5,000.00 range. REPORT OF THE COMMISSION ON BANKRUPTCY LAWS, 54 (1973).

both *Lines* and *Kokoszka*. What is not speculation is that the use in both cases will be the same as wages regularly received, when received—for the necessities of life, as is the case for all low income wage earners.

The Second Circuit Court's emphasis on periodic wage payments as the only source of earnings needed to meet basic needs of life arises from a legal presumption it has drawn which is contrary to fact. *U.S. Dept. of Agriculture v. Murry*, 413 U.S. 508 (1973); *Vlandis v. Kline*, 412 U.S. 441 (1973). As one commentator has noted:

> "Some items which would qualify as basic requirements of life equal in importance to the ongoing expenses covered by vacation pay are not purchased on a weekly or monthly basis, and the annual tax refund may be relied upon to meet such requirements." Note, *The Income Tax Refund As A Possible Asset of A Wage Earner's Bankruptcy Estate*, 87 Harv. L. Rev. 395, 405 (1973).

If Kokoszka is deprived of his tax refund check, he could be forced to meet his required medical or other expenses by borrowing money which would be repaid on a monthly or similar basis. To thus force the bankrupt right back into debt hardly gives him the fresh start which is the purpose of the Act.

B. Since an Income Tax Refund is Part of the Bankrupt's Wages, it Deserves Special Protection.

For wage earner bankruptcies, one of the most critical and consistent concerns in application of the fresh start doctrine has been to protect the bankrupt from his creditor's claims on his subsequent earnings. This Court has recognized that the only opportunity most individual wage earners have to accumulate new wealth in the future

is from the wages they receive subsequent to bankruptcy. For example, in *Traer v. Clews*, 115 U.S. 528, 541 (1885), this Court said:

> "The policy of the bankrupt act was, after taking from the bankrupt all his property not exempt by law, to discharge from his debts and liabilities, and enable him to take a fresh start. His subsequent earnings were his own."

The same important concept was reiterated in *Local Loan Co. v. Hunt*, 292 U.S. 234, 245 (1934):

> "The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much as, if not more than, it is a property right."

No decision of this Court has ever held that a form of personal earnings is property that passes to the creditors.

In this regard, moreover, the bankruptcy cases are only part of a larger legal picture, since wages have a special place in our legal system. Recent decisions only emphasize the fact that *Lines* is a mainstream decision of the law dealing with wages.

The leading case is *Sniadach v. Family Finance Corp.*, 395 U.S. 337 (1969), which held that a person's wages may not be garnished without prior notice and hearing. *Sniadach* was cited as authority in *Lines* the following term. 400 U.S. at 20. Both *Sniadach* and *Lines* were followed by a further series of cases recognizing the critical importance of wages to wage earners. *E.g.*, *James v. Strange*, 407 U.S. 128 (1972) [failure to give a class of debtors the same wage exemptions as others held unconstitutional under 14th Amendment Equal Protection Clause]; *Fuentes v. Shevin*, 407 U.S. 67 (1972) [*Sniadach* applied to personal property as well as wages because *Sniadach* was in the "mainstream of past cases". 407 U.S. at 88]; *Lynch v. Household Finance Corp.*, 405

U.S. 538 (1972) [a person's right to enjoy and preserve property and wages is a basic civil right].

The Second Circuit in the instant case attempted to evade the strong current of decisional law by claiming that the tax refund is not actually wages and thus undeserving of special protection. (App. 32). The court there compared the annual event of the tax refund (without distinguishing between voluntary and involuntary withholding) to a "Christmas Club account or year end dividends". (App. 32). This analogy fails since the wage withholding here is involuntary, not an intentional use of the money. Other examples given by the Second Circuit as property having its source in wages are within a bankrupt's control. (Indeed, he may always sell his stocks, dispose of bank accounts, or not choose, or be in a position, to save at all.) A voluntary fund can be liquidated if it is necessary to provide for basic support. Mr. Kokoszka's case is instructive because surely he needed his involuntarily withheld wages for basic support, which in his case included critical medical needs. A voluntary savings plan of any sort was clearly out of the question, and in fact was not the case here.

The artificiality of the lower court's attempt to identify the refund as a property interest rather than wages is further demonstrated by the facts and policy underlying the withholding sections of the Internal Revenue Code.

The Code requires a wage earner to fill out a withholding exemption certificate for his employer. 26 U.S.C. Sec. 3402(f)(2)(A). The employer then withholds a portion of the employee's wages, calculated according to certain tables, to cover estimated federal income taxes. 26 U.S.C. Sec. 3402(a). Thus the policy of the withholding system compels each employee to prepay part of his wages as an approximation for the tax due after year's end. For various reasons, this approximation may be in

excess, and the United States must return a certain amount of the wages it has withheld.

Because the bankrupt here was compelled for reasons of national policy[3] to involuntarily accumulate part of his wages in anticipation of taxes should not change the nature of the money involved. Nor should the common description of the money as a "tax refund check" affect the fact that it is wages. The *Cedor* court more accurately termed the refund check as "a *forced* overpayment of tax *on wages*". 337 F. Supp. at 1105. It concluded that "there does not appear to be any reason of policy why the amount of the refund should be held to have lost its character as earnings by reason of its somewhat circuitous route to the wage earner's hand". *Id.* at 1107. Se also *In re Freedomland*, 480 F.2d 184, 190 (2d Cir. 1973), *cert. granted sub nom. Otte v. U.S.*, Jan. 21, 1974, where the court said in another bankruptcy context, "Conceptually the [withholding] tax payments should be treated in the same way as the wages from which they derive and of which they are a part".

C. The Principles of *Lines v. Frederick* Govern the Disposition of a Bankrupt's Tax Refund Check Because a Contrary Result Will Not Benefit Creditors.

Like the bankrupt here, most wage earners who are forced into straight bankruptcy have little or no assets

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[3] The court in *Cedor* stated that:

"It is the national interest, according to the provisions of the Internal Revenue Code, to have taxpayers make certain that enough is withheld, so that taxes are promptly paid. The taxpayer is encouraged to err on the side of over-withholding. A decision here that all excess withholding must go to the trustee in bankruptcy would certainly tend to frustrate the objective of the withholding laws." *In re Cedor*, 337 F. Supp. 1103, 1107 (N.D. Cal. 1972), *aff'd sub nom. In re James*, 470 F.2d 996 (9th Cir. 1972), *cert. den.* 411 U.S. 973 (1973).

that are of any value to creditors.[4] *Perry v. Commerce Loan Co.*, 383 U.S. 392, 396 (1966). Why are so few assets available? Professor Charles Seligson, in analyzing bankruptcy cases closed in 1967 and 1968, concluded that:

> "[T]he proceedings were initiated too late, that is after substantially all of the assets of the bankrupts had been dissipated. It must be recognized that most debtors, both in business and non-business, will exert every effort to avoid bankruptcy. Debtors never seem to give up hope that help is just around the corner. To most of society, bankruptcy is an evil word quite often associated with immorality. It is not surprising, therefore, that bankruptcy as an instrument of relief from financial pressures is availed of generally only *in extremis.*" *Major Problems For Consideration By The Commission on Bankruptcy Laws Of The United States*, 45 Am. Bankr. L. J. 73, 86 (1971).

A nationwide, selected survey presents a compelling statistical picture. The data shows that the average

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[4]The average non-business bankrupt owed $5,000 to 12 creditors, mainly finance companies, retail merchants and banks. Stanley & Girth, *op. cit. supra* at 57. The great majority of straight bankruptcies are no-asset cases (70%); a small amount are nominal asset cases (15%) and 15% are asset cases. A Referee in Bankruptcy has concluded that "the more common variety of consumer bankruptcy case is that which is initiated long after the debtor's financial circumstances have fallen into hopeless decline. No realistic prospects for asset recoveries . . . remain. . . . Virtually all of the debtor's non-exempt, unencumbered property is either valueless or has been attached or repossessed long before bankruptcy". Cyr, *Single Claim Jurisdiction*, 46 Am. Bankr. L.J. 199, 226 (1972). Cf. Stanley and Girth, BANKRUPTCY: PROBLEM, PROCESS, REFORM 47, 48 (Brookings Inst. 1971).

dividend to creditors is equal to only seven-tenths of one percent (0.7%) of the unsecured indebtedness.[5]

A similar survey was done in the Northern District of California by the attorneys for the bankrupts in *In re James*, 470 F.2d 996 (9th Cir. 1972). (Brief of Appellees, Appendix A). That study also shows that the dividend to unsecured creditors was less than one percent of scheduled indebtedness.

The bankrupt's case here is the same. Kokoszka's total scheduled unsecured indebtedness is $6,105.22 and his tax refund check is $250.90. The record does not reveal the amount which would be deducted for payment to the trustee and for administration expenses, but the Court below noted that there might be only a very small balance in the Kokoszka estate. *In re Kokoszka*, 479 F.2d 990, 995 (1973) (App. 33).

Similar facts regarding vacation pay caused the Ninth Circuit to note that allowing bankrupts to retain their vacation pay would only rarely harm creditors. *Frederick v. Lines*, 425 F.2d 215, 217 (9th Cir. 1970), *aff'd* 400 U.S. 18 (1970).

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[5] Stanley & Girth, *op. cit. supra* at 90-93 and 232-33. This figure is extrapolated from their data. At page 93 they state that the average dividend to unsecured creditors whose claims were approved and allowed was seven percent (7%), but on page 90 it appears that only ten percent (10%) of unsecured creditors bother to file claims primarily because they have learned that the process is unrewarding. In Appendix B at page 232-33 the authors estimate that the total liabilities of all bankrupts in 1968 was $2,168 million and that creditors received $182 million or nine-tenths of one percent (0.9%). Of course, this includes secured and priority creditors whose percentage return is slightly higher than that of unsecured creditors. *Id.* at 92-3. Thus the seven-tenths of one percent (0.7%) figure seems to be a reasonable estimate based on the raw data.

Income tax refunds, like vacation pay, generally involve small amounts. Two-thirds of all the refunds in one survey were for amounts less than $200.00, and no refund in its sample exceeded $1,000.00; Stanley & Girth, BANKRUPTCY: PROBLEM, PROCESS, REFORM 85 (Brookings Inst. 1971). (Indeed only twelve percent (12%) of the personal bankrupts in the study had to turn over refunds to the trustee. *Ibid.*)[6]

Thus, what happens is that a substantial portion of the assets collected in non-business bankruptcies goes to the very persons who have been appointed to act for the creditors. Stanley & Girth, *op. cit. supra*, found that "41% of the assets of these estates are paid out for trustees' fees and other administration expenses". *In re Kokoszka*, 479 F.2d at 995 (App. 32). In the *In re James* survey, *supra*, the trustees (and their attorneys) consumed fifty-five percent (55%) of the assets collected. Another nine percent (9%) of the assets was consumed by administration expenses.

The Ninth Circuit noted the irony that such assets are consumed by the expenses of administration incurred to obtain the asset. *Frederick v. Lines*, 425 F.2d at 217. The Second Circuit also condemned such a result, stating: "Clearly the purpose of the Bankruptcy Act was to

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[6] Referee Seidman of the District of Connecticut has commented:

> "In the case of a consumer-bankrupt, a potential tax refund covering an overpayment of withholding taxes during the current year *and* wages unpaid at the date of filing *at best* would provide minimal assets to the estate. There is little likelihood of any significant benefit to creditors as there might be in the case of tax loss carry-back of a business bankrupt." [Emphasis added.]

Seidman, *Some Implications of Segal v. Rochelle*, 40 Ref. J. 107, 109 (1967).

benefit creditors and debtors, not trustees." *In re Kokoszka*, 479 F.2d at 995-96 (App. 33).

Against this background of the overwhelming majority of cases, the argument can be made that in an occasional case refunds are large enough, either alone or in combination with other assets, to provide a substantial dividend to creditors. The solution proposed below, *i.e.*, to petition the referee for abandonment of small refunds, adds to the cost and time involved in administration, and involves the exercise of discretion which would undoubtedly erode further the uniformity of the administration of bankruptcy. REPORT OF THE COMMISSION ON BANKRUPTCY LAWS at 122-23 and 15 U.S.C. Sec. 1671(a)(3). It is additionally noteworthy that there has been no abandonment in the case at bar.

At issue herein are the "practical realities", *In re Cedor*, 337 F. Supp. at 1105, in a federal law which should be uniformly stated rather than allocated to the inevitably disparate results of referee discretion.

D. A Decision Exempting an Income Tax Refund From the Assets of the Bankrupt's Estate Does Not Result in a "Head Start" for Some Bankrupts, But Instead it Encourages the Exemplary Goal of Uniform Treatment of all Bankrupts.

The court below cited an obscure phrase in a dissenting opinion by Mr. Justice Harlan in *Lines* when it stated that allowing the bankrupt to exempt his refund from the creditors' claims would provide him with a "head start[7] over others who had no such refund". *In re Kokoszka*, 479 F.2d 990, 995 (App 32).

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[7]In using the phrase "head start", Mr. Justice Harlan was not referring to a head start over other bankrupts. He seemed to refer instead to a head start over a nonbankrupt who started to work on

The fact that one bankrupt may leave bankruptcy with more assets than another seems legally irrelevant. A bankrupt may retain a tort recovery, or an expected inheritance or gift, which would leave that bankrupt with more assets than another. *Segal v. Rochelle*, 382 U.S. 375, 379 (1966); Bankruptcy Act, Sec. 70a(5), 11 U.S.C. Sec. 110a(5). Nowhere in the Bankruptcy Act is such a result prohibited.

Furthermore, state exemptions vary widely. "[S]tate laws governing exemptions are not fair because of the great variations among them, leading sometimes to abuse and at other times to undue hardships. . . ." Enzer, de Brigard & Lazar, SOME CONSIDERATIONS CONCERNING BANKRUPTCY REFORM 11 (Inst. for the Future, 1973).

> "[T]he treatment of exemptions is characterized by both inequities and waste motion. . . . The inequities are largely due to the often obsolete and extremely diverse provisions of state exemption laws." Stanley & Girth, BANKRUPTCY: PROBLEM, PROCESS, REFORM 81 (Brookings Inst. 1971).

See also REPORT OF THE COMMISSION ON BANKRUPTCY LAWS 22, 180 (1973).

Thus, some states have a homestead exemption;[8] Connecticut does not. Some states exempt wages en-

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the date of Mr. Frederick's bankruptcy. The "head start" arose from the state exemption of one half of the pay accrued within 30 days prior to filing the petition, which thus allowed Mr. Frederick to retain a half day's credit of vacation pay. The reverse is true here, since a nonbankrupt would have the benefit of his refund while the bankrupt would not.

[8] Texas' homestead exemption law allowed Ernest Medders to keep 200 acres of land, a $250,000 house, and a $175,000 "party barn". Note, 53 Corn. L. Rev. 663, 665 (1968).

tirely; others "exempt only a ridiculously low set amount"; Connecticut has no such exemption (unless one is provided by the Consumer Credit Protection Act, as the bankrupt argues in Part II hereof.) Cowan, BANKRUPTCY LAW & PRACT. Sec. 630.

It is clear that income tax refunds are treated in this varying manner:

> "Local attitudes affected the practice concerning the collection of tax refunds. None of the cases in Northern Alabama showed this type of asset. Some (though not all) referees in Southern California read a statutory provision giving them discretion to pay trustees up to $150 from the available assets of the estate as permitting them not to collect tax refunds under that amount. . . . Elsewhere, the tax refund was often the only source of compensation for the trustee." Stanley & Girth, *op. cit. supra* at 85-86.

A referee in California confirms that:

> "No doubt, the policy with regard to abandonment of income tax refunds because of the small amount involved varies throughout the country in considerable degree. It varies considerably even in this District. . . . I think it is too much to expect uniformity on this policy of abandonment because of the different conditions which exist in different Districts and different localities within a District." Calverley, *Income Tax Refunds Due Wage Earners*, 39 Ref. J. 8, 10 (1965).

Some referees allow the abandonment of refunds under $150. Snedecor, *Fees and Allowances in Straight Bankruptcy*, 40 Ref. J. 26, 27 (1966); *In re McKenzie*, No. 22635-B-4 (D. Kan. 1972).

In Ohio, an income tax refund of less than $500 is exempt where the bankrupt has no homestead, under a state exemption statute. *In re Perry*, 225 F. Supp. 481 (N.D. Ohio 1963).

In the Ninth Circuit, the income tax refund does not vest in the trustee, except insofar as it results from voluntary withholding. *In re James*, 470 F.2d 996 (1972). Of the voluntary withholding, only 25% vests in the trustee. In the Second Circuit, the refund vests in the trustee. *In re Kokoszka*, 479 F.2d 990 (1973).

Most inequitable of all, "Debtors who are carefully advised and who can wait do not file in bankruptcy until tax refunds have been cashed and spent. . . ." Stanley & Girth *op. cit. supra* at 85. Kokoszka could not wait. Nor did he live in a jurisdiction where his refund would be exempt or abandoned. Compared with other bankrupts, then, Kokoszka does not have a "head start" even if he is allowed to keep the refund.

It is possible that Mr. Justice Harlan or the Second Circuit Court may have linked the phrase "head start" to some fundamental issue of fairness. If so, the question of fairness deserves to be analyzed rather than be cast aside by a quick phrase. The record here reveals that the bankrupt needed his tax refund check for medical expenses which were deferred on account of his pre-bankruptcy financial condition. Because the refund is derived entirely from a forced withholding of wages, there are none of the problems of fairness that troubled this Court about the loss carryback refund in *Segal*. For the bankruptcy court to take an "asset" which the bankrupt was forced by law to accumulate, rather than use for subsistence, is unduly oppressive to the bankrupt.

The commentators have written that the collection of these tax refund checks "are cruel to the bankrupt and productive of costly paperwork". Stanley & Girth, *op. cit. supra* at 86. They recommend a nationwide and uniform exemption law, to produce the most equitable results. Enzer, de Brigard & Lazar, *op. cit. supra* at 11; Stanley & Girth, *op. cit. supra* at 5.

Lastly, the creditor community can derive benefit from a uniform rule of law:

> "Especially from creditors' perspectives, it is important to have rules that determine rights generally in the debtor's wealth wherever situated, and thus guide conduct in the open credit economy, as well as collective processes which effect such rules and permit creditors to realize on their claims." REPORT OF THE COMMISSION ON BANKRUPTCY LAWS 84 (1973).

The Ninth Circuit decision in *In re James* establishes a uniform rule of law, thus determining rights in a manner that might guide creditor conduct in a multistate credit economy. A contrary decision which may allow some creditors to receive a few cents on the dollar, cannot guide creditors and is needlessly cruel to debtors.[9]

E. A Wage Earning Bankrupt's Tax Refund Check is not Like the Tax Loss Carryover in *Segal v. Rochelle.*

In *Segal v. Rochelle*, 382 U.S. 375 (1966), this Court noted that two, sometimes competing, purposes of the Bankruptcy Act are to give a debtor a fresh start and to distribute assets to the bankrupt's creditors. *Segal v. Rochelle*, 382 U.S. at 379. The balance in *Segal* was

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[9] Referee Calverley also noted that there is considerable delay either in getting information from the I.R.S. or in securing the refund check. Even if the time for filing objections to the discharge has expired, a discharge can be reopened and denied if the refund is not turned over to the trustee. Calverley, *Income Tax Refunds Due Wage Earners*, 39 Ref. J. 8, 10, 11 (1965). This procedure seems administratively very costly, extremely cruel to the bankrupt, with benefit running mainly to the trustee in a fee to compensate for his time.

tipped in favor of the creditors because the bankrupts would be discouraged from earning if the loss carryback refund were available to them, and because it seemed unfair to reimburse the bankrupt for business losses which his creditors had been forced to bear.

Yet, the Second Circuit chose to regard a wage earner's refund as analogous to the loss-carryback tax refund of a business bankrupt in *Segal v. Rochelle*, rather than to the accrued vacation pay of the wage earners in *Lines*. Close analysis reveals that the *only* similarity between *Segal* and *Kokoszka* is that both involve money returned to a bankrupt by the Internal Revenue Service.

Segal involved a business bankrupt, not a wage earner. The Court in *Segal* was not particularly concerned with the fresh start doctrine, because the tax loss carryback refund belonged to "a business [that] has ceased to operate". *Lines v. Frederick*, 400 U.S. at 19. Here we have an individual wage earner, as in *Lines*, who survives the bankruptcy and needs whatever income comes to him thereafter for his fresh start.

Thus, *Segal* stands for little more than the proposition that the fresh start concept did not apply to its unique facts; indeed it emerges as the exception along the landscape of fresh start cases decided by this Court.

Furthermore, the nature of the loss carryback refund (a "very special situation", *In re Sussman*, 289 F.2d 76, 78 (3d Cir. 1961)) raised unusual problems of fairness. A loss carryback refund would have reimbursed the business for losses it sustained in previous years. However, upon bankruptcy, the business no longer sustained the losses; they were passed on to its creditors. Thus fairness required that any payment for those losses also be passed on to the creditors. With a wage earner, an income tax refund is the result of an involuntary approximation of taxes owing. No money is paid to the wage-earning

bankrupt for his economic losses which are now borne by his creditors. The only payments a personal bankrupt might receive that could be construed as government reimbursement for such losses are workmen's compensation or unemployment insurance. *Segal* does not apply to such payments. The logic of *Segal* is simply inapplicable to income tax refunds.

There are other distinctions between *Segal* and the instant case. The wage-earner, practically speaking, can expect a tax refund "as an annual event", *In re Cedor*, 337 F. Supp. at 1105, especially if, as in Mr. Kokoszka's case, he is unemployed, sick or otherwise unable to work for part of a year. In terms of a "fresh start", deprivation of this fund is not any less severe than deprivation of vacation pay, since both losses may lead to some period of future support at an income level lower than that which would cover basic needs. Similarly, families may rely on the receipt of these funds and defer the purchase of necessities until the expected receipt. In contrast, the tax loss carry-back in *Segal* would have resulted in a significant windfall to the Segals personally, since the business which generated the losses had dissolved.

The relationship of both *Segal* and *Lines* to a wage earner bankrupt's tax refund check was correctly analyzed by District Court Judge Albert Wollenberg, *In re Cedor*, 337 F. Supp. 1103, 1105 (N.D. Cal. 1972).

> "Here the Court is confronted with elements of both *Segal* and *Lines*. The funds are received as a tax refund, but the refund is generated by the provisions of the Internal Revenue Code requiring certain amounts to be withheld from wages under given circumstances. In *Segal* the refund amounted to the recovery of a part of the taxes paid on profits in earlier years because of losses in the operation of a business in the taxable year; these losses also were a precipitating cause of the bankruptcy.

In the instant cases, the Court is concerned with the refund of what was, in effect, a *forced* overpayment of tax *on wages*. There is nothing to suggest that the sums refunded were related to the circumstances which precipitated the bankruptcy. The Supreme Court considered the question in *Segal* to be 'close', 382 U.S. 379, 86 S.Ct. 511, 15 L.Ed.2d 428; in light of *Lines* and *Snaidach* [sic], the balance on this question tips in favor of the bankrupt. The collection by the Internal Revenue Service without the consent or control of the bankrupt, and the belated refund, render these funds quite similar in a practical sense, to the accrued but unpaid wages which constituted vacation pay. If *Lines* stands for anything, it is that the practical realities are controlling in this determination."

The *Cedor* opinion has received the support of leading academic commentators. Note, *The Income Tax Refund as a Possible Asset of a Wage Earner's Bankruptcy Estate*, 87 Harv. L. Rev. 395 (1973); Countryman, *The Use of State Law in Bankruptcy Cases I*, 47 N.Y.U.L. Rev. 407, 461 (1972). As the Harvard Law Review commentator said:

"The characteristics of refunds resulting from mandatory overwithholding present a more compelling case for retention by the bankrupt than loss-carryback refunds in that their ties to the past are less clear, their importance for an individual's fresh start is more evident, and their status as a form of compensation to a wage earner is such as to require greater protection than that afforded business-related refunds." 87 Harv. L. Rev. at 406.

A secondary test in *Segal* was whether the fund was "sufficiently rooted in the pre-bankruptcy past". 382 U.S. at 380. In *Segal* a true "tax" refund was available,

because the refund was from taxes already paid on business profits in earlier years. Mr. Kokoszka's refund was no more than a wage refund because a tax liability never arose.

Furthermore, a tax refund can accrue to a wage-earner not only from the loss of a job before filing a petition, but also from events which may follow a petition, such as marriage or the birth of a child. Thus, a wage-earner's tax refund is not rooted in the past, but is often contingent on events future to the date of filing the bankruptcy petition.

When a wage-earner files a bankruptcy petition, the court's duty is "to secure for creditors everything of value the bankrupt may possess in alienable or leviable form *when he files his petition*" and "to leave the bankrupt free *after the date of his petition* to accumulate new wealth in the future." *Segal v. Rochelle, supra* at 379 (Emphasis added.) Thus the filing date draws a "line of cleavage" across the bankrupt's life. *Everett v. Judson*, 228 U.S. 474, 479 (1913).

A recent comment suggests that although the "line of cleavage" argument has not been "wholly dispositive" of past cases,[10] that a:

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[10]In *In re Aveni*, 458 F.2d 972 (6th Cir.) *cert. den.*, 409 U.S. 877 (1972), the Sixth Circuit held that non-exempt wages, recently accrued, presently owing and payable substantially current with bankruptcy are property. *Aveni* dealt with a different question from this case, and in fact affirmed that wages the bankrupt cannot collect until some date subsequent to the bankruptcy do not pass to the trustee. *Id.* at 973. It concluded, however, that non-exempt wages immediately payable are an exception to *Lines* because: (1) the receipt of the wages is virtually contemporaneous with the bankruptcy proceedings and (2) the bankrupt's ability to make a fresh start was not threatened, especially since he was able to claim the very substantial exemption against garnishment allowed by state law.

"Modification of the past-future distinction to focus on *time of payment* rather than date of earning supports the treatment of refunds resulting from mandatory withholding as 'future earnings' when they will not be received until a number of weeks after the date of filing. Such refunds are generally less accessible to a bankrupt at the time of filing than was the vacation pay considered in *Lines*. Since they are not disposable by a wage earner until received, such refunds are distinguishable from other assets with a source in wages which have been allocated to a voluntary use by the wage earner." [Emphasis added.] Note, 87 Harv. L. Rev. 395, 403-04 (1973).

F. The Traditional Bankruptcy Principle That a Debtor Should Have a New Start Combines With the Equity Powers of the Court To Require That, on Balance, a Wage Earner's Involuntarily Withheld Income Tax Refund Is Exempt From the Claims of His Creditors.

Many of this Court's decisions in bankruptcy emphasize the "overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction". *Bank of Marin v. England*, 385 U.S. 99, 103 (1966). The fact that creditors in this case and the overwhelming majority of tax refund cases would receive only a pittance for their efforts has been fully documented. The balance, viewed in light of fairness, tips to the debtor who has deferred but necessary basic obligations which he counts on his tax refund to meet.

Even if the equities were equally compelling for each party, the traditional test of the "fresh start", free from pre-existing debt, must weight the scale to the wage earner. In *Perez v. Campbell*, 402 U.S. 637 (1971), the Court, speaking through Mr. Justice White, voided an

important and substantial creditor interest when it ruled that a state financial responsibility law, which "made 'it more probable that the debt will be paid despite the discharge' . . . frustrated Congress' policy of giving discharged debtors a new start". *Id.* at 650.

There is a guiding principle which emerges from the cases: If the possible asset is wages and is involuntarily withheld until a future date, since in the vast majority of cases the wages withheld will be used for future basic support or necessities of life, and will not provide any meaningful benefit to creditors, the asset should not be treated as "property" under Sec. 70a(5) of the Bankruptcy Act.

II.

EVEN IF THE REFUND IS PROPERTY VESTING IN THE TRUSTEE, 75% OF THE REFUND IS EXEMPT FROM GARNISHMENT BY THE TRUSTEE UNDER THE PROVISIONS OF THE CONSUMER CREDIT PROTECTION ACT.

The Consumer Credit Protection Act, 15 U.S.C. Sec. 1673, exempts from garnishment 75% of an individual's disposable earnings. The bankrupt argues here that the income tax refund, even if it is "property", is entitled to the 75% exemption enjoyed by all other wage payments under the provisions of the Consumer Credit Protection Act. Only if the income tax refund is "property" need the Court consider this question.

A. The Income Tax Refund Is Protected From Excessive Garnishment Because It Comes Within the Terms of the CCPA.

The trustee takes title to the bankrupt's property "except insofar as it is property which is held to be

exempt". Bankruptcy Act, Sec. 70(a), 11 U.S.C. Sec. 110a. The Bankruptcy Act does "not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States. . . ." Bankruptcy Act Sec. 6, 11 U.S.C. Sec. 24.

Such an exemption is that found in the Consumer Credit Protection Act, 15 U.S.C. Sec. 1671 *et seq.*, which exempts from garnishment 75% of an individual's disposable earnings. The trustee's claim to the income tax refund is a "garnishment" of "disposable earnings" within the statutory definitions.

Earnings

The basic statutory definition in the Consumer Credit Protection Act (CCPA) is that of "earnings". If the refund comes within that definition, it then falls into the protected category of disposable earnings.

" '[E]arnings' means compensation paid or payable for personal services, *whether denominated as wages*, salary, commission, bonus, *or otherwise*, and includes periodic payments pursuant to a pension or retirement program." 15 U.S.C. Sec. 1672(a). (Emphasis added.) There can be no dispute that the refund here consists entirely of compensation payable for personal services, even though it is "denominated as" an income tax refund.

On the face of the statute, then, the refund comes within the definition of earnings. As Judge Wollenberg noted:

> "There does not appear to be any reason of policy why the amount of the refund should be held to have lost its character as 'earnings' by reason of its somewhat circuitous route to the wage-earner's hands." *In re Cedor*, 337 F. Supp. 1103, 1107 (N.D. Cal. 1972); Accord, *In re Freedomland*, 480 F.2d 184, 190 (2d Cir. 1973).

Contrary to the assertion of the court below, the definition of earnings is not limited to weekly or periodic payments. The statutory definition itself contemplates such nonperiodic payments as a bonus or commission. It also contemplates earnings for pay periods other than weekly, when it mandates the Secretary of Labor to prescribe a formula for determining the exemption as to such pay periods. 15 U.S.C. Sec. 1673(a).

In accordance with the statute, the Secretary of Labor has promulgated a regulation which provides that, "The 25 percent part of the formula would apply to the *aggregate* disposable earnings for *all* the workweeks compensated". 29 C.F.R. Sec. 870.10(c)(1). [Emphasis added.] The tax refund may compensate for several workweeks, but under this regulation, the trustee could take only 25% of the aggregate.

It is irrelevant that the wages included in the refund may have been earned several weeks or months in the past. The statute makes no distinctions or exceptions that derive from the time of receipt. Moreover, the Secretary of Labor found inadequate a state statute which limited restrictions on garnishment to wages earned within the previous 30 days. He explained that "the garnishment restrictions of [the Act] apply without limitation as to when wages were earned". Op. WH-121 (Feb. 5, 1971). 6A BNA Labor Rel. Rep. WHM 95:198p, at q.

Disposable Earnings

To come within the protections of the CCPA, the refund must not only be "earnings", but "disposable earnings". The Consumer Credit Protection Act defines the term "disposable earnings" as "that part of the earnings of any individual remaining after the deduction from those earnings of any amounts required by law to be withheld". 15 U.S.C. Sec. 1672(b).

The refund is within the definition of "earnings". The entire amount is "disposable earnings" because nothing is required by law to be deducted or withheld from those earnings.[11] When the earnings comply with the definition of disposable earnings, that is, at the time the wages withheld for taxes are returned to the bankrupt, the restrictions on garnishment apply.

Garnishment

Garnishment is defined as "any legal or equitable procedure through which the earnings of any individual are required to be withheld for payment of any debt". 15 U.S.C. Sec. 1672(c).

In bankruptcy, the trustee is "vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding. . . ." Bankruptcy Act Sec. 70a, 11 U.S.C. Sec. 110a. He takes title to property as both an attaching and executing creditor. Bankruptcy Act. Sec. 70c, 11 U.S.C. Sec. 110c; Cowan, BANKRUPTCY LAW & PRAC., Sec. 623 (Supp. 1972).

"The process by which the trustee takes title is certainly 'a legal or equitable procedure', and the purpose of requiring the trustee to marshal the assets of the bankrupt is to pay the debts of the bankrupt." *In re Cedor*, 337 F. Supp. 1103 at 1107.

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[11] "It is not material in determining whether sick pay constitutes earnings that it may not be subject to withholding and FICA deductions. Sick pay is included in the 'disposable earnings' to which the Act's garnishment restrictions apply because such pay is a component of compensation paid or payable for personal services or 'earnings'." Op. Secretary of Labor (Feb. 1, 1973), 6A BNA Labor Rel. Rep. WHM 95:198z, at aa.

Bankruptcy itself is a "legal or equitable procedure".[12] In addition, the referee here ordered Kokoszka to deliver the refund to the trustee. (App. 2). Such a court proceeding is one to which the Consumer Credit Protection Act applies. Op. Secretary of Labor WH-32 (May 18, 1970), 6A BNA Labor Rel. Rep. WHM 95:188.

Traditionally, garnishment refers to a levy upon a person who owes money to the debtor. But nothing in the Consumer Credit Protection Act definition of garnishment incorporates the traditional concept of a third party. Certainly the definition is not limited to situations where the employer possesses the funds.

> "Nor do we believe that the restrictions contained in section 303(a) of the Act are limited to situations where the exempt wages are still in the hands of the employer. . . . The restrictions apply to earnings *paid or payable. . . . Certainly we should not impose upon the statute restrictions or limitations which would tend to defeat or restrict the manifest purposes of the Act.*" [Emphasis added.] Op. Secretary of Labor WH-146 (Oct. 26, 1971) 6A BNA Labor Rel. Rep. WHM 95:198o, at p.

Recently, the Secretary of Labor sought and obtained an injunction against the practice of attaching or executing upon a paycheck as personal property. The Sheriff's argument was that attachment and execution are not garnishments under the CCPA. The court rejected this contention, saying:

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[12] "[W]e regard an Internal Revenue Service attachment of wages for taxes due the United States as a 'legal procedure' within the meaning of Section 302(c) of Title III even in those cases where an actual court proceeding has not taken place." Op. Secretary of Labor WH-77 (Sept. 14, 1970), 6A BNA Labor Rel. Rep. WHM 95:197.

"[T]he Act applies to proceedings in aid of execution as well as attachment proceedings. This construction is clearly arrived at by an ordinary reading of the statutory language used in 15 U.S.C. Sec. 1672. The term "garnishment" is not restricted, but includes any procedure by which earnings of an individual are withheld. In view of this, whatever definition is given to "garnishment" for other purposes (those discussed in 30 AM JUR.2d *Executions* Sec. 1; 18 WORDS AND PHRASES 130, etc.), for the purpose of this decision the restrictions of the CCPA are applicable to proceedings under North Dakota law in aid of execution in all courts, as well as proceedings in 'execution of the judgment'." *Hodgson v. Christopher*, 365 F. Supp. 583, 586-87 (D. N.D. 1973).[13]

The refund ("earnings") is "required to be withheld" in several senses. First, title is required to be withheld when by operation of law, title to the refund vests in the trustee upon the filing in court of the bankruptcy petition.

Second, when the trustee notifies the Internal Revenue Service of his right to the refund, it is often sent by the IRS directly to the trustee in accordance with internal

[13]This interpretation is supported by the legislative history of the Consumer Credit Protection Act. As initially passed by the House, only 10% of the excess over $30 "of any wages, salary or earnings in the form of commission or bonus as compensation for personal services may be attached, garnished or subjected to any legal or equitable process or order". 114 Cong. Rec. (Feb. 1, 1968) H 713. In the conference committee, Congress increased the amount that could be garnished to 25% of the excess, but broadened the definition of earnings to cover all possible situations, and used a broad definition of the term garnishment to cover as many ways of taking as possible.

procedures. *In re Jones*, 337 F. Supp. 620, 621 (D. Minn. 1971). Indeed, the IRS views the refund as belonging to the trustee in bankruptcy. Rev. Rul. 72-387, 1972-2 C.B. 632. The refund is certainly withheld from the bankrupt in this event.

It is required to be withheld in a third sense when the bankruptcy court orders the bankrupt to turn over the refund or assist the trustee in obtaining it for the estate. (App. 2). If the bankrupt exercises any property rights in the refund thereafter, he risks denial of discharge or contempt proceedings. Bankruptcy Act Sections 14c(6), 41a(1); 11 U.S.C. Sections 32(c)(6), 69(a)(1).

Under the above analysis of the statutory terms, an income tax refund is within the restrictions against garnishment.

B. Other Provisions of the CCPA Confirm Its Applicability to the Income Tax Refund.

The application of the garnishment restrictions to the refund in a straight bankruptcy proceeding is mandated by the specific sections of the Consumer Credit Protection Act discussed above. It is also supported by other provisions of the CCPA.

The Congressional findings and declaration of purpose make it clear that the drafters of the garnishment sections were aware of the Bankruptcy Act as a whole and contemplated application of the garnishment sections to bankruptcy matters. In fact, the Consumer Credit Protection Act rests on both the bankruptcy and commerce powers of Congress. 15 U.S.C. Sec. 1671(b).

One of the concerns underlying the Consumer Credit Protection Act is the evil resulting from unrestricted garnishments. But a separate and distinct concern is that "the great disparities among the laws of the several states relating to garnishment have, in effect, destroyed the

uniformity of the bankruptcy laws and frustrated the purposes thereof in many areas of the country". 15 U.S.C. Sec. 1671(a)(3). On the basis of this finding, "Congress determines that the provisions of this subchapter [on garnishment restrictions] are necessary and proper . . . to establish uniform bankruptcy laws". 15 U.S.C. Sec. 1671(b).

As noted *supra* p. 20, the bankruptcy laws are anything but uniform with respect to treatment of income tax refunds. A decision that only 25% of any such refund passes to the trustee would establish a more nearly uniform rule and insure that debtors are treated comparably regardless of their residence. It would also further the intent of Congress.

Further, the Consumer Credit Protection Act provides that the garnishment restrictions do not apply to "any order of any court of bankruptcy under Chapter XIII of the Bankruptcy Act". 15 U.S.C. Sec. 1673(b)(2).[14] "[U]nless the Sec. 1673(b)(2) exception of orders in Chapter XIII proceedings is surplusage, Congress must have intended that the Act's restrictions on garnishment should apply to other, similar orders of the bankruptcy court not within the terms of the exception," *In re Cedor*, 337 F. Supp. 1103, 1107 (N.D. Cal. 1972).

For instance, orders under Sec. 17c(3), 11 U.S.C. Sec. 35c(3) ("render judgment and make all orders necessary for the enforcement thereof") would be subject to the 25% garnishment limitation in accordance with the intent

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[14]Chapter XIII gives the bankruptcy court the power to order the employer of a Chapter XIII debtor to withhold from the bankrupt's pay and turn over to the trustee whatever periodic amounts the debtor has agreed to pay to the trustee under the terms of his wage earner plan.

of the statute. And, where the trustee takes title to wages for services already performed, "The limitations of the Consumer Credit Protection Act will cut down the right of the trustee to 25% of the wages. . . ." Cowan, BANKRUPTCY LAW & PRAC. Sec. 623 (Supp. 1972).

After establishing restrictions on garnishment, and three narrow exceptions thereto, Congress underscores its intent. "No court of the United States or any State may make, execute, or enforce any order or process in violation of this section." 15 U.S.C. Sec. 1673(c).

Congress acted in contemplation of the Bankruptcy Act with the intent to promote uniform bankruptcy laws. It adopted definitions which include the income tax refund. In any event, the statute, being a remedial one, must be broadly construed to effectuate its purpose. *Wilder v. Inter-Island Steam Nav. Co.*, 211 U.S. 239, 246 (1908) (statute protecting seamen's wages liberally interpreted); *Peyton v. Rowe*, 391 U.S. 54, 65 (1968); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

C. The Interpretations of the Secretary of Labor Support Bankrupt's Position.

The Secretary of Labor, acting through the Wage and Hour Division, is charged with the enforcement of the garnishment provisions of the Consumer Credit Protection Act. 15 U.S.C. Sec. 1676. This Court has frequently applied the "venerable principle that the construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong. . . ." *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969); *Lewis v. Martin*, 397 U.S. 552, 559 (1970); *Zemel v. Rusk*, 381 U.S. 1, 11 (1965).

Interspersed in the above arguments were certain of the agency's interpretations which support bankrupt's

position. More to the point, an opinion of Robert D. Moran, Wage and Hour Administrator, states in full:

> "This is in reply to your letter of October 21, 1970, concerning Title III, Restriction on Garnishment, of the Consumer Credit Protection Act.
>
> It is not clear from your letter whether a voluntary petition in bankruptcy is involved or whether there has been a petition filed under Chapter XIII of the Bankruptcy Act. The exemption in section 303(b)(2) of the Act runs only to orders of the Bankruptcy Court under Chapter XIII. *Any other order* of a Bankruptcy Court would appear subject to the garnishment restrictions provided in Section 303(a)." [Emphasis added.] Op. WH-103, Dec. 18, 1970, 6A BNA Labor Relations Rep. WHM 95:198h.

Thus, the Wage and Hour Division interprets the garnishment restrictions literally to accomplish the purpose of the statute to protect the wage earner. It has stated that "[T]he garnishment restrictions of Title III apply without limitation as to when wages were earned". And, "Under Title III, a garnishment writ may *never* cause *any* withholding of *any* earnings in excess of that subjected to garnishment under section 303(a)". [Emphasis added.] Op. Secretary of Labor WH-121 (Feb. 5, 1971), 6A BNA Labor Rel. Rep. WHM 95:198p.

Under the interpretations of the Wage and Hour Division, the earnings of a debtor do not lose their exempt character by being deposited by the employer in a bank account:[15]

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[15] "[I]t is believed that employees generally withdraw all of the funds before the next pay day." Op. Secretary of Labor WH-146 (Oct. 26, 1971), 6A BNA Labor Rel. Rep. WHM 95:198o.

"The Act's restrictions apply to earnings or compensation paid or payable for personal services. It would be contrary to the express mandate of the Act to assume that when a debtor deposits his earnings for safekeeping in a bank, his earnings are transformed into a bank credit to which the Act's restrictions do not apply." Op. Secretary of Labor WH-171, (Aug. 3, 1972) 6A BNA Labor Rel. Rep. WHM 95:198r.

A fortiori, when wages are "deposited" with the United States Government by the employer, and the debtor cannot choose to expend or invest them, they are capable of identification as earnings and subject to the restrictions on garnishment.

Thus, the interpretations of the administering agency support bankrupt's position that his refund remains earnings and 75% of the refund is protected from garnishment by the trustee.

CONCLUSION

The bankrupt here seeks a ruling that his income tax refund is not property of his estate in bankruptcy. Such a ruling would implement the basic purpose of the Bankruptcy Act to give him a fresh start in life. A contrary ruling would provide only a token benefit to creditors.

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[15] *(cont.)*

Op. WH-171, quoted in the text, cites a number of cases in which payments, such as veteran's benefits or workmen's compensation, retain their exempt character when deposited by the debtor in a bank account, when such payments are necessary or intended for the support of the debtor. In *Lawrence v. Shaw*, 300 U.S. 245 (1937), this Court stated that such exempt payments retain their exemption "until expended or invested" under the statute there interpreted.

Alternatively, the bankrupt contends that the trustee is entitled to no more than 25% of the wages returned to him in the form of an income tax refund, under the Consumer Credit Protection Act. Such a ruling would accomplish Congress' intent to protect a wage earner's income, whatever form it takes.

For all of the reasons above stated, this Court is respectfully requested to reverse the ruling of the Second Circuit Court of Appeals.

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Appendix A

The statutory provisions involved herein are as follows: Bankruptcy Act §6 (11 U.S.C. §24), which states:

> "This title shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition in the State wherein they have had their domicile for the six months immediately preceding the filing of the petition, or for a longer portion of such six months than in any other State: *Provided, however,* That no such allowance shall be made out of the property which a bankrupt transferred or concealed and which is recovered or the transfer of which is avoided under this title for the benefit of the estate, except that, where the voided transfer was made by way of security only and the property recovered is in excess of the amount secured thereby, such allowance may be made out of such excess."

Bankruptcy Act §70a (11 U.S.C. §110a), which states:

> "(a) The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in ap-

plications therefor: *Provided,* That in case the trustee, within thirty days after appointment and qualification, does not notify the applicant for a patent, copyright, or trade-mark of his election to prosecute the application to allowance or rejection, the bankrupt may apply to the court for an order revesting him with the title thereto, which petition shall be granted unless for cause shown by the trustee the court grants further time to the trustee for making such election; and such applicant may, in any event, at any time petition the court to be revested with such title in case the trustee shall fail to prosecute such application with reasonable diligence; and the court, upon revesting the bankrupt with such title, shall direct the trustee to execute proper instruments of transfer to make the same effective in law and upon the records; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: *Provided,* That rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction, and criminal conversation shall not vest in the trustee unless by the law of the State such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process: *And provided further,* That when any bankrupt, who is a natural person, shall

have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the policy shall pass to the trustee as assets; (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this title, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court.

All property, wherever located, except insofar as it is property which is held to be exempt, which vests in the bankrupt within six months after bankruptcy by bequest, devise or inheritance shall vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date when it vested in

the bankrupt, and shall be free and discharged from any transfer made or suffered by the bankrupt after bankruptcy.

All property, wherever located, except insofar as it is property which is held to be exempt, in which the bankrupt has at the date of bankruptcy an estate or interest by the entirety and which within six months after bankruptcy becomes transferable in whole or in part solely by the bankrupt shall, to the extent it becomes so transferable, vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date of bankruptcy.

The title of the trustee shall not be affected by the prior possession of a receiver or other officer of any court."

Consumer Credit Protection Act, 15 U.S.C. §1671, entitled "Congressional Findings and Declaration of Purpose", states:

(a) The Congress finds:

(1) The unrestricted garnishment of compensation due for personal services encourages the making of predatory extensions of credit. Such extensions of credit divert money into excessive credit payments and thereby hinder the production and flow of goods in interstate commerce.

(2) The application of garnishment as a creditors' remedy frequently results in loss of employment by the debtor, and the resulting disruption of employment, production, and consumption constitutes a substantial burden on interstate commerce.

(3) The great disparities among the laws of several States relating to garnishment have, in effect, destroyed the uniformity of the bankruptcy laws and frustrated the purposes thereof in many areas of the country.

(b) On the basis of the findings stated in subsection (a) of this section, the Congress determines that the provisions of this subchapter are necessary and proper for the purpose of carrying into execution the powers of the Congress to regulate commerce and to establish uniform bankruptcy laws."

C.C.P.A., 15 U.S.C. §1672, entitled, "Definitions", states:

"For the purpose of this subchapter:

(a) The term 'earnings' means compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus, or otherwise, and includes periodic payments pursuant to a pension or retirement program.

(b) The term 'disposable earnings' means that part of the earnings of any individual remaining after the deduction from those earnings of any amounts required by law to be withheld.

(c) The term 'garnishment' means any legal or equitable procedure through which the earnings of any individual are required to be withheld for payment of any debt."

C.C.P.A., 15 U.S.C. §1673, entitled, "Restrictions on Garnishment—Maximum Allowable Garnishment", states:

"(a) Except as provided in subsection (b) of this section and in section 1675 of this title, the

maximum part of the aggregate disposable earnings of an individual for any workweek which is subjected to garnishment may not exceed

(1) 25 per centum of his disposable earnings for that week, or

(2) the amount by which his disposable earnings for that week exceed thirty times the Federal minimum hourly wage prescribed by Section 206(a) (1) of Title 29 in effect at the time the earnings are payable.

whichever is less. In the case of earnings for any pay period other than a week, the Secretary of Labor shall by regulation prescribe a multiple of the Federal minimum hourly wage equivalent to that set forth in paragraph (2).

Exceptions

(b) The restrictions of subsection (a) of this section do not apply in the case of

(1) any order of any court for the support of any person.

(2) any order of any court of bankruptcy under chapter XIII of the Bankruptcy Act.

(3) any debt due for any State or Federal tax.

Execution or enforcement of garnishment order or process prohibited

(c) No court of the United States or any State may make, execute, or enforce any order or process in violation of this section."